

INITIAL STATEMENT OF REASONS NON-CONTROLLING SUMMARY

PROPOSED AMENDMENTS TO REGULATION 1602, FOOD PRODUCTS

Amendments to Regulation 1602 are proposed to provide a clear standard for taxing sales of combination packages that include food and nonfood products (such as gift baskets) sold for a single price and to eliminate obsolete language in subdivisions (a)(1), (a)(2), (a)(3), and (a)(4) of Regulation 1602.

Specific Purpose

The purpose of the proposed amendments to Regulation 1602 is to interpret, implement, and make specific Article XIII, Section 34, of the California Constitution and section 6359 of the Revenue and Taxation Code, and to eliminate obsolete language currently contained in this regulation. This regulatory change is necessary to provide guidance to taxpayers affected by these provisions of law and to delete regulatory language that is no longer needed.

Factual Basis

On June 23, 2005, Target Corporation sent a letter to the CRA requesting that a bright-line test be used for taxing sales of combination packages that include food and nonfood products (such as gift baskets) sold for a single price. The letter was forwarded to the Board of Equalization (Board) Business Taxes Committee for consideration. A similar letter was received from Longs Drugs on November 14, 2005.

The provision of current subdivision (b) of Regulation 1602 regarding combination packages has been in existence for over fifty years. During this time, the retail industry has changed substantially. As Target Corporation and Longs Drugs, as well as CRA and CGA explained, when this regulation was written, retailers made their own combination packages, which allowed them to itemize the individual components, determine the single price of each item, and collect the proper amount of tax. Sales were manually rung up at checkout and separate itemization was possible. Today, combination packages containing food and nonfood products (such as gift baskets) are mostly manufactured by a distributor or manufacturer. The retailer pays a single price for the combination package and markets it for a single price. Retailers do not know the cost of each individual item and thus are unable to readily value the components for combination packages. Most retailers use point of sale (POS) checkout scanning equipment and most products have barcodes. The systems used by retailers do not allow for separate itemization of a single barcode item.

As a result, some retailers are reporting their sales tax liability on an arbitrary amount and choosing to absorb the tax burden by not collecting sales tax reimbursement from their customers. Others are reporting and paying tax on the full selling price of the combination packages and collecting the tax reimbursement from their customers on the full amount paid. This is causing them to be sued by consumers claiming the retailers knowingly collected excess tax reimbursement (on sales that are nontaxable under Regulation 1602), even though the retailer remitted the entire amount collected to the Board.

Subdivision (b) of Regulation 1602 currently provides that when a package contains both food products (e.g., dried fruit) and nonfood products (e.g., wine or toys), the application of tax depends upon the essential character of the complete package. If more than 10 percent of the retail value of the complete package, exclusive of the container, represents the value of the nonfood products, a segregation must be made and the tax measured by the retail selling price of such nonfood products. Furthermore, sales of combination packages that include food products and nonfood products are considered exempt sales of food if:

1. The retail value of the food contents is at least 90 percent of the retail value of the total package contents, and
2. The retail value of the package container is 50 percent or less of the retail value of the entire package.

Sales of combination packages that do not meet both of the above-conditions are subject to tax based on the selling price of the entire package less the value of the food. In addition, to claim an exemption for the sale of food products in the combination package, retailers' records must separately state the value of the food and nonfood products and those values should be separately stated on the invoice or receipt.

The Board, in agreement with the California Retailers Association (CRA), the California Grocers Association (CGA), and the National Association of Theatre Owners of California/Nevada (NATO), proposes amending Regulation 1602, Food Products, subdivision (b), Sales of Combination Packages, as follows:

- If the retailer has documentation to establish the cost of the individual component parts of the combination package and the retail value of the nonfood products exceeds 10 percent of the selling price of the entire package, exclusive of the container, the retailer must continue to segregate the selling price of the food and nonfood products. The measure of tax consists of the retail selling price of the nonfood products.
- If the retailer does not have documentation to establish the cost of the individual component parts of the combination package and the retail value of the nonfood products exceeds 10 percent of the selling price of the entire package, exclusive of the container, the tax may be measured by the retail selling price of the entire package.
- If the retail value of the nonfood products is 10 percent or less, exclusive of the container, and the retail value of the container is 50 percent or less of the retail value of the entire package, the selling price of the entire package is not subject to tax.

In addition to the proposed revisions to subdivision (b), the Board proposes deleting obsolete language in subdivisions (a)(1), (a)(2), (a)(3), and (a)(4) of Regulation 1602 and renumbering within subdivision (a) as necessary. The text proposed for deletion is based on statutory provisions in effect between July 15, 1991, and November 30, 1992, that excluded snack foods, candy, gum, confectionery, and bottled water from the definition of food products.

The proposed amendments to subdivision (b) balance the statutory and constitutional provisions regarding exempt sales of food products with the various needs of the retail industry. The

proposal would allow retailers who purchase prepackaged combination packages of food and nonfood products as a single-priced item from their distributor or manufacturer and who have no documentation to support the cost or markup of the individual components, to report tax measured by the retail selling price of the entire package when more than 10 percent of the retail value represents the value of the nonfood products.

On the other hand, those retailers who have documentation that enables them to establish the cost and retail selling price of the individual components of the combination package must continue to segregate the retail value of the food and nonfood products, with the tax measured by the retail selling price of such nonfood products. Such segregation avoids having retailers that sell combinations of food and nonfood products (e.g., a theater selling a candy bar and soda) for a single price report tax on the entire sales price, when the retailer knows the retail selling price of each individual item in the combination package. Typically, these retailers purchase and sell food and nonfood products separately, and create their own combination packages by offering sales of these products for one price to their customers. Therefore, the cost and retail selling value of each product is known to the retailer and the use of segregated pricing can be maintained.

The proposed amendments would result in the taxation of transactions involving sales of food products when the retail value of the nonfood products of the combination package exceeds 10 percent of the retail value of the entire package, exclusive of the container. This is permissible because all gross receipts are presumed subject to tax until the contrary is established and the burden of proving that a sale of tangible personal property is exempted or excluded from tax is generally upon the person who makes the sale.

The proposed amendments reasonably interpret Article XIII, Section 34, of the California Constitution, which specifies that “[n]either the State of California nor any of its political subdivisions shall levy or collect a sales or use tax on the sale of, or the storage, use or other consumption in this State of food products for human consumption except as provided by statute as of the effective date of this section” and Revenue and Taxation Code section 6359, which specifically exempts sales of food products from tax.

Alternatives Considered

The only reasonable alternative to amending Regulation 1602 is to maintain the existing regulation. However, as discussed above, the existing regulation does not address changes that have taken place in the preparation of combination packages of food and nonfood products. In order to address these changes, the Board has worked with the retail industry to develop a clear standard that takes current practices into consideration when determining the application of tax to combination packages of food and nonfood products.

Initial Determination

Based on discussions with the retail industry, the Board has made an initial determination that the proposed amendments will not have a significant adverse economic impact on private business or persons. The amendments are proposed to interpret, implement, and make specific the authorizing statutes. These amendments will provide a clear standard for the application of tax to sales of combination packages of food and nonfood products and will also eliminate obsolete provisions in the regulation.